Workshop by CBBH & St. Antony's College, Oxford

The Impact of the Euro crisis and Investment opportunities in Bosnia and Herzegovina

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Session:

The Impact of the Euro crisis on the Financial Stability in Bosnia and Herzegovina and the region

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Speaking notes:

1. I would like to thank the organizers for the invitation, hosts for the great venue; as always, Oxford is an extremely stimulating environment for intellectual exercises and confrontations (explain why confrontation is good for creativity). There is only one big drawback for having this Workshop here, the opportunity cost of not seeing Sarajevo again. But, ten minutes is not much to talk about the euro crisis alone, to say nothing about its impact, especially on the region and on BiH in particular. I have organized my comments around the following topics. First, clarify a little bit the term euro crisis and its magnitude, second, talk about the impact on the financial system in particular, and finally, have a look into the crystal ball to foresee the possible consequences for BiH and the region.

   I want to say that the topic of financial stability is very dear to my heart. Long before the crisis I advocated the need for central banks in the region to have a financial stability review. I have read my memos to the CBBH from June 2006, when we started working on the FSI, on the reorganization of the department, etc. I am very pleased to say that much was achieved.

   It is interesting to mention that almost five years ago, in mid-September 2007, we celebrated the 10th anniversary of the Central Bank of Bosnia and Herzegovina. I attended the second session: "Monetary Stability in the Function of Financial Stability" and the title of my presentation was "Financial Challenges for the B10 Central Banks". Boy, was I right. Although there were not many banking or financial crises in the region, central banks had a full plate dealing with financial stability in those last five years and will continue to do so. But first the good news, not only for the first ten, but for the whole fifteen years, the central bank has successfully kept its currency board. This is no small feat, solid reserves, the principles of currency board preserved and, as far as I can see from the aggregates, the credibility of the currency is there. Congratulations to the Governor (and, of course, to his predecessor, as well as to all CB board members and staff). I have no doubt that the credibility of the currency board will continue. However we should not take it for granted, as I will try to explain.

2. What is the euro crisis? By the euro crisis I do not mean only the crisis of the eurozone, but all the underlying crises behind it. It is a sovereign debt crisis, it is a real sector crisis and a financial/banking crisis at the same time. But first of all, it is a crisis of confidence, confidence in the existing model. We have to face the harsh reality. There will be no big bang solution, no quick remedies, and no silver bullet. The adjustment will take several years, there will be a lot of volatility, both because of the negative news (like the recent elections) and more positive ones (for example, the IMF war chest increase, LTRO, i.e. ECB's flexibility, the fiscal compact). But again, we in the region should be ready for a period of several years of either negative or neutral (at best) influence from our environment. So, when making a comparison with the situation five years ago, now we know that this turbulence will last longer, with much bigger consequences than initially expected. Please remember this. Bad economic prospects also carry increasing risks for political and social stability.
3. Impact on the financial system in the region.
    - The trade channel (exports, including tourism). If our main trading partner in the EU/eurozone is facing recession and/or low(er) growth this will impact our growth and, consequently, the financial system stability. The impact is clear. Low growth, negative expectations, low demand for loans, low deposit growth, the NPL ratio remains high, etc.
    - Contagion via increased sovereign risk for the region, for example Croatia's CDS went up from about 200 to 530 basis points and recently fell somewhat, but the difference is at least 3 percentage points. This is partly caused by domestic reasons, but partly also by a different risk perception due to the euro crisis.
    - The banking channel (the structure of the banking industry, foreign banks). In 2012 we can expect either no new capital inflows (either capital and/or deposits, especially long-term) or even deleveraging and outflows due to Austria's regulator LDR of 110%, RBA's and Erste's announcements of deleverage (even exit) from some countries. Vienna seems to be dying if not dead, and some countries might experience a credit crunch..
    - Again the banking channel, but via bad news that may create (another) run on banks. When our banks were privatized, reputable foreign owners added credibility to the domestic banking system, now it seems to work the other way around.

   For some countries that have banks from the countries in bad shape like Greece, those risks are exacerbated, although the countries with Italian and Austrian banks are not completely safe either.

   • Uncertainties about the euro in general create negative expectations for domestic savings and investments. We daily receive a lot of questions about what will happen to savings and economies if the euro disappears. Advanced

economies have always been looked up to and creating positive expectations, and this is now challenged.
According to a recent EBRD blog:

- The region is experiencing a net capital outflow, for the first time since 2009 (and data for February 2012 are still on that track).
- Parent banks are deleveraging, at least through Q4. Banks are losing cross-border funds.
- Credit growth has become very weak. Partly due to the lack of domestic demand, partly due to changed risk perception in the region.

The problem is that it is all going to affect the medium to long-term growth potential. Bosnia's growth. Prior to the crisis, like elsewhere in the region, with capital inflows driving a domestic demand boom, internal and external imbalances worsened. Loose fiscal and public wage policies also contributed to the overheating of the economy. The crisis triggered a collapse in the demand for BiH exports and severely curtailed cross-border financial inflows. The banking system came under strain, as the spate of negative news about foreign banks with subsidiaries in BiH triggered a mini-deposit run in late 2008. Again, this is a deep structural crisis, not only a cyclical one. We will again have growth, but it will be (at least according to the available information we have today) more modest; potential growth is estimated to amount between one half and two thirds of the previous growth.
Financial stability report. For 2010, it looks good, and I am not saying that either the CBBH or Banking Agencies are not doing a good job, on the contrary. But given the magnitude of the crisis we have faced and are still facing there is not only a shift in the paradigm, but a shift in the perception of the overall riskiness of the system. So, yes, the financial system in BIH is undeniably riskier today than it used to be before the crisis. I am not saying it is crisis-prone, but it would be an illusion, delusion, call it what you want, to think that with such a negative international environment and weak domestic demand it is completely sound..
I have to say that it is very difficult to assess the stability of the financial/banking system in BiH without access to data and visiting the country. So, my apologies in advance if I badly miss some points. But my general comments are as follows.

1. Special attention should be paid to the safety net. By the financial safety net we usually assume deposit insurance and the LOLR. Sometimes prudential regulation, supervision and or bank resolution are included. A living will.

My understanding is that deposit insurance in BiH is modern, well organized.
The LOLR is an especially big problem for BiH. We know well the limits of the CBBH. This is nothing new, but before the banking crisis we thought that parent banks would step in. Today we know this might not happen, i.e. due to their huge problems at home and diminished prospects for growth in the region, their decision to continue investing in the region should not be taken

for granted. Yes, bad things do happen, what before the crisis was considered as an outlier, a very improbable event that “will not happen” today is looked at differently. Black swans exist, we have seen them, they tend to multiply faster than white ones, do they not, faster than we would like them to.

About ten years ago in Sarajevo, there was a lot of talk about the so-called moral hazard issue. Commentators said that the lack of the LOLR was not a problem because if anything bad happened “the West” (however defined, including IFIs) would step in, they would not allow the currency board to explode (or, rather, to implode) as this might cause a risk of another war in BiH and nobody wanted that. Maybe there was some merit in this before the crisis. But today, with all EU governments (and the USA) having their plates full with their own problems, with agendas filled with Greece, Italy, sovereign debt, with domestic elections being lost due to austerities and rising nationalism at home, my own assessment is that the probability for a foreign intervention to step in and substitute the LOLR is smaller than it was before. I put aside the IMF, but we know from Argentina’s example that IMF programs alone are typically insufficient to prevent the crisis. And the IMF, in spite of its increased war chest of USD 440 billion (at least on paper), may be busy designing policies to rescue Spain or even Italy, and all those institutions have limited resources, both human (the staff and the management’s attention span) and financial.

BiH should stop thinking of itself as a special case. The war’s hardships were terrible, but you will neither get the Olympic Games (big business) nor any unconditional help on account of sympathy. Don’t count on international help in any case.

My conclusion is that the crisis has undoubtedly increased the riskiness of the system. We may not capture those risks via the measurements we have at our disposal (either on a systemic level or on a bank by bank level), but for me the world is simply a riskier place than it was in 2007. My main worries are for the medium and long run. Both banks and macro policy makers will have to devise a new growth model.

Do not forget that regulators are like generals after the battle. We are now changing regulation basically to prevent the type of crisis that has happened. It is difficult to say what lies ahead.

The idea of making a distinction between diversity and diversification is the one I consider particularly important.

4. Statistical data. The IMF says that the data are broadly adequate for surveillance, but *de facto* there is very little BiH in various comparative frameworks on stability and the real sector. I would like to reemphasize the need for serious investment in statistics, not necessarily at the CBBH but in Bosnia in general, especially on the broad level.

   This year, the persistent economic weakness in the euro area is likely to be a continued drag on the global economic expansion. The perception that there is no clear solution to the deeply-rooted problems of the euro area is weighing on confidence, both in the region and globally. In addition, the euro area's close banking and investment linkages with other economies have adversely impacted financial conditions elsewhere, most notably in Emerging Europe and Emerging Asia. The euro area itself is likely to experience a mild recession this year, before resuming a sluggish growth path. According to our projections, the euro area's weakness is the main reason why we have seen global growth slowing to just below 3% this year before reaccelerating to nearly 4% in 2013. Some notable features of the current expansion include:

Impact from the world.
•Further downside risks in the global economy relate to credit problems lingering from the last cycle. Bank deleveraging remains a key constraint, especially as banks respond to tougher regulatory guidelines. Large budget deficits will be cut, often under market duress.
•Excessive private sector credit growth bears watching in many large emerging economies. The combination of favourable investor sentiment, a global policy push to promote emerging market domestic demand and low starting levels of business and household leverage, could combine to produce credit accidents, especially as the cycle matures in 2014-15.
The bottom line is, problems will not go away.
This is a very serious, deep structural crisis, not only for BiH, but for the region and Europe as well.
I often repeat, yes we will have growth, but it will be different, probably lower (as a trend) and definitely based on other causes than in the past (i.e. much lower foreign capital inflows, lower domestic consumption growth) so that expectations have to be altered.
Second, as it seems from the available data, BiH still has a huge external imbalance, even in crisis, and growth below 1%; its CAD is 6-7%. This clearly and plainly means that the country is living beyond its means. To the extent that FDI are "sound", non-debt creating inflows, it is fine, but otherwise this is something to be worried about.
The most difficult thing is to change the mentality.
The last FSR from the CBBH, which is very good, is for 2010. And I am sure that whenever the new one is published, it will have equally good results, if not better. And they will be genuine. However, I would like to warn against complacency.
We are facing a quest for a new growth model not only for Europe, but for our countries, including BiH, in the future. In addition to us, banks also have to face the harsh reality that a ROE of 20+ and growth rates of loans (and deposits) of 30%+ per year are only in the past, not in the future any time soon. I am too old to say never again, but one does not see anything remotely resembling those growth rates in the next five years. On the contrary, what I do see are further shocks, coming both from the eurozone and from our own countries.

I see growing pressures in the social/political sphere, growing populism and nationalism (look at Greece, France), false promises that protectionism and cheap rhetoric will “save our rights”.
We have to understand that there are no rights. Nothing is granted.
We live in the world of multiple equilibria, or to put it bluntly, bad outcomes can happen. Unless different approach is taken, the BiH currency board may break, yes it can.
We really do not know much about our economies. For a long while we were saying the convergence model. I would still think of it as positive. However, recent analyses have shown that countries correlated with the EU suffer more. So unless the EU gets its act together and starts to behave, we are hostages, are we not. We have to be humble, beware of complacency. Humble with regard to how much we know about the functioning of the systems.
Vulnerabilities and imbalances usually grow steadily over the years, and then all of a sudden, our perception changes, Discontinuities in the system.
I see the external imbalance as a problem for BIH.
The EU is far away, the eurozone even further, I would not dare predict today any of the dates. But, we have seen that neither is a safe haven. Both are helpful, I am sure much more countries would be in trouble without Eu or being in euro zone, but the periphery, GIPS, etc., demonstrate that we still have to be very vigilant and pay attention.
We live in the world of the new normal, the past is a bad predictor of the future, and we can no longer extrapolate and presume.
The role of foreign banks. In Croatia they definitely saved the government in 2008 and 2009 with additional inflows. And lending to the government. And more generally, (Winkler) there is no evidence that they contributed to the financial shock, amplified it (they did not).
But we cannot neglect the risk existing in the future.
My main message concerns this discontinuity. We implicitly tend to linearly extrapolate the past. My message is, forget it.
Some jump to conclusions that we should not privatize banks to foreign owners. But in the case of Croatia, as mentioned, they played a very positive role, they still do, there is no destabilizing impact, but it seems quite evident that in the future we should be more careful, i.e. we cannot expect their exposure to increase.
A legitimate question is what might happen in a year or two if the crisis is over. Will they continue lending i.e. increasing their exposure?
Of course I do not know. It will depend on their home strategies.
But I can tell you this. Foreign banks came to the region because they did not grow fast enough at home. Italy, for example.
Technically speaking, they want a positive EVA (economic value added). EVA is simply defined as the difference between the ROAE (usually after tax) and the cost of capital that the owners think is reasonable. How much, depends on

the individual banks and it is not easy to find those data. But of course the higher the risk the higher the cost of capital will be.

Ask yourself. Why would I invest in the capital of a bank, which is risky by the very nature of the business, if for that money I can buy the government bonds without any effort t? So, if a bond sells for, say, 6% one would expect the cost of capital for that bank to be above that.

To ensure that banks stay and grow, i.e. invest in the future, policymakers need to do two things, both are easier said than done:

1. Create conditions for sound growth in the future. Again, sound sustainable growth is a precondition.
2. Make the sovereign risk as small as possible i.e. increase the country's rating.

   So, again this boils down to what a business friendly environment is. This is not the topic, but my message is: to keep the financial system in Bosnia stable in the medium term one needs to keep foreign banks. And to do that, we need business friendly policies (which are obviously lacking), and think about the sovereign rating.

   Credit growth driven by capital inflows (mostly via foreign banks).

   I would say prioritize, prioritize and prioritize. And to prioritize means keeping the banks safe. To do this you need:

   a) to keep the trust of the domestic population in banks, in any way you can, and
   b) to ensure that, for different reasons, the economy has to grow.

      With regard to social and other tensions, growth is again crucial. How to grow is a billion dollar question, but without growth in the medium term you cannot have stability.

In the last episode of this soap opera we saw what happens if banks grow too fast. I am afraid that unless we find a balance, we might see the consequences of banks not growing fast enough.